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Global: Global Rebalancing and Dollar Risk
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For the past three years, I have expressed deepening concerns about the mounting imbalances of a US-centric global economy. A rebalancing of this lopsided state of affairs is the only means by which the world can finally start to function again as an organic global economy. And I have a tough time envisioning how such a realignment would occur without a significant further correction in the dollar. The biggest unknown, in my view, is the ultimate pace of dollar depreciation -- the speed of which could well have critical impacts on world financial markets and the global economy.

It's fruitless to blame any one nation for the unbalanced state of affairs in the global economy. It is just as much America's problem as it the responsibility of the rest of the world. America has continued to live beyond her means, as those means are delineated by the US economy's domestic income generating capacity. But over the past decade, most other nations in the world have either been unwilling or unable to stimulate domestic demand. In my view, this is not a sustainable state of affairs. A saving-short, increasingly-debt-financed US economy is flirting with the perils of a destabilizing current-account adjustment. Trade-dependent nations elsewhere in the world -- especially Japan and Europe -- are running the risk of currency revaluations that could undermine their only source of growth. Against this backdrop, the case for rebalancing seems compelling. Yet there is still a general sense of denial that such a realignment is the only way out.

Indeed, courtesy of America's stunning resurgence in the second half of 2003, a US-centric world has gone back to its old ways. Over the 1995 to 2002 period, our estimates suggest that the US accounted for fully 96% of the cumulative increase in world GDP (nominal dollars as converted by market exchange rates). Throughout the long sweep of post-World War II experience, this is the modern-day world economy's most extreme bout of unbalanced growth. The requisite rebalancing could be driven by a combination of two developments -- a weaker dollar and/or a narrowing of the growth disparities between the US and the rest of the world. Such a development appeared to be under way in the first half of 2003: The combined impacts of a modest further weakening in the dollar (down 4.5% in real terms for the broad trade-weighted index) and a sluggish US economy (2.4% real GDP growth and only 4.1% nominal growth) resulted in a meaningful reduction in America's contribution to world GDP growth. But then the US economy went on a tear, with real growth probably averaging close to 6.5% in the second half of this year. This compares with average real GDP growth of only about 2.2% in the rest of the developed world -- leaving little doubt that even on a currency-adjusted basis, America has recaptured the magic of the US-centric global growth paradigm.

Nor has there been any real let-up in America's outsize claim on the global saving pool. The net national saving rate in the US plunged to a record low of 0.6% in the first three quarters of 2003. That left America with little choice other than to import surplus saving from abroad in order to finance economic growth -- and run massive current account and trade deficits in order to attract that capital. According to the Bank for International Settlements (BIS), the portion of global saving required to fund the US current-account deficit has more than tripled since 1997. The bulk of this saving has come from Asia, while a much smaller portion is traceable to Europe. Within Asia, the incremental saving growth has come mainly from the region's emerging economies, such as Korea and Greater China; Japan's national saving rate, as well as its current account surplus, has remained high but relatively stable in recent years. It's not as if the world has resisted this arrangement. Demand deficient and surplus-saving economies in Asia and Europe have been more than willing to fund excess demand in the United States. Moreover, by recycling the bulk of this surplus capital into US Treasuries and quasi government paper (i.e., agencies), foreign investors are keeping US interest rates lower than otherwise would be the case -- thereby providing an added source of stimulus to the world's main engine of demand growth. Perhaps the most disturbing element of the external financing conundrum is that it is not stable. America's rapidly deteriorating fiscal position points to steadily mounting US current-account deficits, which place ever-increasing claims on global saving. That means foreign investors will need to increase their already overweight positions in dollar-denominated assets in order to keep the US-centric global growth dynamic going.

Ultimately, it boils down to the question of sustainability. There's a financial aspect to this question -- whether surplus saving economies are willing to keep funding America's imbalances without demanding any compensation for increasingly overweight positions in dollar-denominated assets. There's a general belief that any shortfall of dollar buying from private foreign investors can be offset by increased demand from central banks and treasuries around the world. In that vein, it's important to note that fully 73% of the world's official foreign exchange reserves remain lodged in dollar-based instruments (as of the latest official data point for year-end 2002) -- an enormous overweight that is more than double America's 30% share in the global economy. There's also a host of "real-economy" considerations to the question of sustainability -- from mounting trade deficits and jobless recoveries in the US to suppressed domestic consumption and potential investment bubbles in surplus saving economies elsewhere in the world. In addition, as election cycles heat up, there are tough domestic political considerations to consider -- namely, the increasingly protectionist tendencies to shield workers who are bearing the brunt of external imbalances, trade deficits, and heightened import penetration. And there are equally vexing geopolitical considerations that bear on the issue of sustainability -- namely the willingness of the world to accept American hegemony on financial, economic, military, and even social terms. These are thorny considerations, to be sure, but they lay bare a tough set of pressures that must be finessed

if a lopsided US-centric global economy is to stay its present course.

The dollar may have the final say in this great debate. A rebalancing of an unbalanced global economy cannot occur without a shift in relative prices, in my view. That puts unmistakable downward pressure on the dollar -- the world's most important relative price. In broad, trade-weighted terms the dollar has fallen about 10% (in real terms) over the past 22 months -- a quintessential soft landing. Based on current-account adjustments of the past, the dollar's downward adjustment may only be half over, at best (see Caroline Freund, "Current Account Adjustments in Industrialized Countries," Federal Reserve International Finance Discussion Paper No. 692, December 2000). What matters most, however, is the speed by which the dollar gets from point A to point B. A continued soft landing is consistent with the scenario of a benign current account adjustment. A rapid decline -- the so-called hard landing in the dollar -- would undoubtedly wreak havoc on financial markets and the world economies.

Macro provides a framework that lays out the tensions bearing down on the dollar. But it falls short in being able to make the distinction between the soft- and the hard-landing outcomes. The verdict on that count probably plays more on the intangible aspects of a faith-based currency. Today's imbalances are large enough such that a sudden loss of confidence in expected returns on dollar-denominated assets could trigger a sharp sell-off in the currency. It's anyone's guess as to what might spark such a turn in sentiment. My top two candidates -- an escalation of protectionist trade actions by the US or a downside growth scare in the real economy. The basic point is that the die is cast for a significant further downward adjustment in the foreign exchange value of the dollar. The pace of the remaining portion of this correction depends almost entirely of the reaction of the foreign investor community -- private as well as official -- to those periodic shocks that always seem to occur.

Conventional wisdom amongst investors and policy makers is that America's current account and currency adjustment will be benign -- playing out at a measured pace over a number of years. Federal Reserve Chairman Alan Greenspan recently endorsed just such an outcome (see his remarks at the 21st Annual Monetary Conference, Co-sponsored by the Cato Institute and The Economist, Washington, DC, November 20 2003). Nor is he alone in calling for yet another soft landing. As I travel the world, the common response that I get when speaking of the potential for a further drop in the dollar refers to the belief that Washington wouldn't dare let the currency fall sharply before the upcoming presidential election. That reflects a deeply held view that the authorities have both the will and the means to offset the powerful confluence of market-driven and psychological forces. The soft landing, of course, has always been the preferred way out of tough circumstances. Yet sometimes, the exit strategy is determined by forces that transcend the will and determination of mere mortals.

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